

**Franchise Tax Board****ANALYSIS OF ORIGINAL BILL**

Author: Kuehl Analyst: Anne Mazur Bill Number: SB 1014  
Related Bills: See Legislative History Telephone: 845-5404 Introduced Date: February 23, 2007  
Attorney: Tommy Leung Sponsor: \_\_\_\_\_

**SUBJECT:** Impose Additional Tax On Income That Exceeds \$200,000, Self-Employment Income, & Nonwage Income/Health Care Coverage Tax/California Health Insurance System Funding Law

**SUMMARY**

This bill would do the following:

- Impose additional taxes on certain wage income and nonwage income to fund a universal health care plan.
- Impose an excise tax on employers based on wages paid.
- Impose specified duties on the Employment Development Department (EDD).

This analysis addresses only provisions in the bill that impact the Franchise Tax Board (FTB).

**PURPOSE OF THE BILL**

According to the author's staff, the purpose of this bill is to provide funding for a universal health care program for all Californians.

**EFFECTIVE/OPERATIVE DATE**

This bill would be effective January 1, 2008. The bill specifies an operative date for taxable years beginning on and after January 1, 2008.

**POSITION**

Pending.

**ANALYSIS****FEDERAL/STATE LAW**

Residents of California are taxed on their entire taxable income (TI), regardless of source, while nonresidents are taxed only on TI from California sources. A part-year California resident's TI for the year they change residency is the sum of the entire TI during the portion of the year they were a resident and the TI from California sources during the portion of the year the taxpayer was a nonresident.

Board Position:

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Department Director

Date

Selvi Stanislaus

4/26/07

The rate of tax for the 2006 tax year ranges from 1% on TI under \$6,622 for single and separate returns, under \$13,244 for joint returns, and under \$13,251 for heads of household to a maximum of 9.3% on TI over \$43,467 for single and separate returns, over \$86,934 for joint returns, and over \$59,166 for heads of household. These tax brackets are indexed for inflation each year. Once the tax is calculated, a variety of credits are allowed to reduce the tax. These credits include personal exemption credits, dependent credits, and various incentive credits.

Beginning with the 2005 taxable year, state tax law imposes an additional 1% tax, not subject to reduction by credits, on the portion of a taxpayer's taxable income that exceeds \$1 million. The estimated revenue from the additional 1% tax is deposited into the Mental Health Services (MHS) fund on a monthly basis, subject to an annual adjustment.

Wages received by individuals for employment in California are subject to withholding for state purposes of both disability insurance and personal income tax. The amount withheld for personal income tax is dependent on the amount and frequency of wages paid and on filing status and exemption information provided to the employer. For 2007, the State Disability Insurance wage base is \$83,389 and the contribution rate is 0.6%, for a maximum contribution of \$500.33.

For federal purposes, under the Federal Insurance Contributions Act (FICA), in addition to withholding for personal income tax, wages are subject to withholding for both social security<sup>1</sup> and Medicare. For 2007, the social security tax wage base limit is \$97,500. The employee tax rate is 6.2%, for a maximum contribution of \$6,045. The employee tax rate for Medicare is 1.45%. There is no wage base limit for Medicare tax. Employers are required to pay social security and Medicare tax on wages paid in the same amount of the employee contribution. Self-employed individuals pay social security and Medicare taxes in an amount generally equal to an employee's plus employer's share of social security tax and Medicare. For 2007, the 12.4% social security tax is computed on the first \$97,500 of self-employment income, for a maximum contribution of \$12,090. The 2.9% Medicare tax is computed on the entire self-employment income. Half of these combined amounts, or 7.65% of self-employment income, is allowed as a deduction.

### THIS BILL

For taxable years beginning on and after January 1, 2008, this bill would impose an additional tax at an unspecified rate on the portion of an individual taxpayer's TI that exceeds \$200,000, with an additional unspecified rate on TI that exceeds \$1 million. This additional tax could not be reduced by credits.

For taxable years beginning on and after January 1, 2008, this bill also would impose an additional tax at unspecified rates on the following:

- The self-employment income of every individual taxpayer.
- The nonwage income of every individual taxpayer.
- The wages of every individual taxpayer.

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<sup>1</sup> Social security is also known as OASDI for Old Age, Survivors, and Disability Insurance.

This bill would define “self-employment income” to mean the net earnings from self-employment, as defined by the Internal Revenue Code, made by an individual, excluding any amount less than \$7,000 or more than \$200,000. This bill would define “nonwage income” as the amount of adjusted gross income (AGI) minus net earnings from self-employment, minus the amount of any wages, received by an individual. Nonwage income excludes any amount in excess of \$200,000. The term “wages” would be defined by a specified article of the Unemployment Insurance Code (UIC), but would exclude any amount less than \$7,000 or more than \$200,000. The tax on wages would be subject to withholding by the EDD based on a method determined by the FTB. This bill would provide that the additional taxes on TI, self-employment income, and nonwage income would be subject to the estimated tax payment requirements, and also the interest, penalty, and other tax administration rules, as prescribed with respect to taxes imposed under Revenue and Taxation Code section 17041.

This bill also would impose an “excise” tax on employers at an unspecified rate on the wages paid to employees. For this purpose, the term “wages” would exclude any amount over \$200,000 paid to each employee. This tax and the tax on employee wages would be administered by the EDD; however, both FTB and EDD would be required to establish rules and regulations to implement these provisions of the bill.

The bill would specify that the proceeds of the additional tax are to be deposited in the Health Insurance Fund and shall be continuously appropriated to the California Health Insurance Agency for specified purposes.

The bill would also require, by November 15, 2008, FTB, in consultation with the Legislative Analyst, to establish by regulation a transfer rate and mechanism for the revenue generated as a result of the additional tax rates. The bill specifies that the transfer rate and mechanism shall be based on those set forth in the provision that created an additional 1% tax on taxable incomes over \$1 million enacted by Proposition 63.

The bill would require wage withholding by employers of the amount of taxes reasonably estimated to be due for the additional tax on wage income.

#### IMPLEMENTATION CONSIDERATIONS

The bill would require the department to draft regulations based on the MHS tax to prescribe how certain provisions of this bill would be implemented. Based on that requirement, the department anticipates implementing this bill in the same manner, including the establishment of the transfer rate and funding mechanism, which would require changes to the computer systems, forms and instructions, and processing procedures.

The bill would require FTB to draft regulations to implement various provisions of the bill. Because of the lengthy process of developing regulations, such regulations likely would not be in place by the January 1, 2008, operative date of the bill. In the alternative, staff suggests that the mandatory regulation language be changed to a permissive grant of rulemaking authority to allow FTB to issue regulations as necessary. It is likely that some provisions of this bill could be implemented without going through the regulation process.

The bill would add new Part 10.1 to the Revenue and Taxation Code for the California Health Insurance Premium. Provisions under this part would add a new tax on wages for both employees and employers to be administered and enforced by EDD. To avoid confusion for employers, employees, and administrators, staff suggests that this part might be more appropriately placed in the UIC, where many of the definitions and rules that would be applicable to this part currently reside.

The department encountered issues in implementing the MHS tax involving how to apply the tax to nonresidents or in unusual filing situations such as partnership group returns, trusts, and other provisions that require withholding of tax computed at the "top marginal rate." Similar issues would need to be resolved in order to implement this bill.

The bill would define "nonwage income" with reference to AGI, as defined in Section 62 of the Internal Revenue Code. The language of the bill is silent with respect to adjustments to federal AGI pursuant to California law. If it is the author's intent to reference federal AGI as adjusted for California purposes, it is suggested that the bill be clarified to achieve this result.

Under existing law, individual taxpayers with TI under specified thresholds are not required to file tax returns. It is suggested that the bill be clarified to indicate whether the filing thresholds would continue to apply if a taxpayer was subject to one or more of the taxes that would be imposed by this bill. If not, the volume of tax returns filed would increase substantially as would the burden imposed on the impacted taxpayers.

#### TECHNICAL CONSIDERATIONS

On page 6, line 9, strikeout "article." and insert "chapter." in lieu thereof.

This bill would require the revenues collected as a result of the additional taxes to be deposited into the Health Insurance Fund for purposes of administering health care benefits under the California Health Insurance System. Because the fund and the health insurance system would be created under another bill, SB 840 (Kuehl, et al.), should this bill be enacted without the passage of SB 840 the department would be unable to deposit the revenues into the appropriate fund. The author may wish to amend both bills to include contingent enactment language or combine both bills into one.

Staff also notes that the names used in this bill and SB 840 for the health care system and the fund do not agree. Specifically, SB 840 uses the names "California Universal Healthcare System" and "Universal Healthcare Fund." This bill uses the names "California Health Insurance System" and "Health Insurance Fund."

## **LEGISLATIVE HISTORY**

SB 840 (Kuehl, et al., 2007/2008) would create the California Health Insurance System that would provide health care benefits to all individuals in the state. It would also create the California Health Insurance Premium Commission. FTB's Executive Officer would be required to be a member of the commission. This bill is currently in the Senate Rules Committee.

SB 48 (Perata/Kuehl, 2007/2008) would establish the California Health Care Coverage and Cost Control Act, which would require every employed person or self-employed person to maintain a minimum policy of health care. This bill is currently in the Senate Health Committee.

SB 840 (Kuehl et al., 2005/2006) would have established the California Health Insurance System that would provide health care benefits to all individuals in the state. It would have also created the California Health Insurance Premium Commission. FTB's Executive Officer would be required to be a member of the commission. The bill was vetoed by the Governor stating in part, "...I cannot support a government-run health care system."

SB 1784 (Kuehl, 2005/2006) would have imposed on individuals an additional tax on TI, self-employment income and nonwage income in the same manner as in SB 1014. This bill was held in Senate policy committees.

## **FISCAL IMPACT**

The department's costs to administer this bill cannot be determined until implementation concerns are identified and resolved, but are anticipated to be significant, particularly because new lines and schedules must be added on certain tax returns to capture the new tax data. Additional lines would require new system programming, forms design, forms printing, and data capture. Staff will continue to develop costs as the bill progresses.

## **ECONOMIC IMPACT**

Without specified percentages for the tax increase, the department is unable to provide a revenue estimate.

Using the threshold amounts provided in the bill, department staff estimates there would be approximately 424,000 taxpayers with TI between \$200,000 and \$1 million and 48,000 taxpayers with TI equal to or greater than \$1 million. Staff also estimates there would be approximately 1 million taxpayers subject to tax on self-employment income between \$7,000 and \$200,000. The approximate number of taxpayers subject to tax on nonwage income under \$200,000 would be 7.6 million. The approximate number of taxpayers subject to tax on wage income between \$7,000 and \$200,000 would be 11.1 million. All of these individual taxpayers would be impacted by this bill.

## **ARGUMENTS/POLICY CONCERNS**

Funding based on additional taxes imposed on high-income taxpayers creates uncertainty because the amount of income reported by high-income taxpayers is volatile.

A provision in this bill would impose an additional tax rate on taxable income that exceeds \$200,000 and \$1 million. These thresholds are the same regardless of filing status. As such, this bill may provide an incentive for more married couples and registered domestic partners to determine whether it would be beneficial for file separate rather than joint returns<sup>2</sup> in order to avoid these new taxes on TI. Filing separately would allow such individuals to split their taxable income, the result of which may be under the specified thresholds that would trigger the new tax.

The additional taxes proposed in this bill would increase the complexity of complying with California income tax laws for many taxpayers. A substantial increase in complexity can have a negative impact on the voluntary nature of the tax system. More complexity also increases the rate of errors on tax returns.

## **LEGISLATIVE STAFF CONTACT**

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<sup>2</sup> In general, individual taxpayers are required to use the same filing status for California purposes as they do for federal purposes. Married couples would therefore have to file separately for federal purposes if they wanted to do so for California. Effective for taxable years beginning in 2007, registered domestic partners are required to file jointly or separately by applying the standards applicable to married couples under federal income tax law, regardless of federal filing status. (SB 1827, Stats. 2006, Ch. 802.)